

## INITIAL STATEMENT OF REASONS FOR RULE CHANGES UNDER THE FRANCHISE INVESTMENT LAW

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the proposed amendment, adoption or repeal of Sections 310.114.1 and 310.156.3 of the California Code of Regulations (10 C.C.R. Sections 310.114.1 and 310.156.3).

### Section 310.114.1 – The Offering Circular In General

The Department of Corporations ("Department") regulates the offer and sale of franchises under the Franchise Investment Law ("FIL"). (Cal. Corp. Code Sections 31000-31516). Under the FIL, it is unlawful to offer or sell any franchise in this state unless the offer has been registered with the Commissioner of Corporations ("Commissioner") or is exempt from registration.

Corporations Code Section 31114 requires that an application for registration of a franchise be accompanied by a proposed offering circular that contains the material information set forth in the application for registration as specified by rule of the Commissioner. Section 310.114.1, requires that the offering circular comply with the Uniform Franchise Offering Circular ("UFOC") Guidelines, as amended by the North American Securities Administration Association, Inc. on April 25, 1993. (See Section 310.111(b).) Corporations Code Section 31114 also provides that the Commissioner may require additional disclosures. Pursuant to this authority, Section 310.114.1 sets forth additional disclosures that must be included in the offering circular, including several disclosures relating to renewal, termination, transfer, and dispute resolution under Item 17 of the UFOC.

### Section 310.114.1(c)(5)(A)&(c)(5)(B)(iv)

Under existing law, subsection (c)(5)(A) of Section 310.114.1 requires a disclosure that California Business and Professions Code Section 20000 through 20043 provide rights to franchisees concerning termination or non-renewal of a franchise, and that if a franchise agreement contains a provision that is inconsistent with the law, the law will control. In addition, subsection (c)(5)(B)(iv) of Section 310.114.1 requires that the franchisor disclose, if the franchise agreement requires binding arbitration, the location of the arbitration and the party who will bear the cost of the arbitration. Furthermore, the franchisor is required to disclose that the binding arbitration provision of the franchise agreement "may not be enforceable under California law."

Among the rights provided to franchisees under California Business and Professions Code Sections 20000 through 20043, is Section 20040.5, which provides

that a provision in a franchise agreement that restricts venue to a forum outside the State of California is void if the claim relates to or arises under the franchise agreement and involves a business operating within the State of California. However, the 9<sup>th</sup> Circuit Court of Appeals recently found Section 20040.5 preempted by the Federal Arbitration Act (“FAA”) in the case of a forum selection clause for arbitration. See Bradley v. Harris Research, Inc. (2001) 275 F.3d 884, 890.

Because of the ruling of the 9<sup>th</sup> Circuit Court of Appeals in Bradley, *supra*, the Commissioner proposes to amend subsection (c)(5)(A) of Section 310.114.1. The proposed amendment to subsection (c)(5)(A) of Section 310.114.1 requires a franchisor to include the following statement: “Business and Professions Code Section 20040.5 relating to forum selection clauses restricting venue outside the state of California for arbitration may be preempted by the Federal Arbitration Act. Section 20040.5 may still apply to any provision relating to judicial proceedings.” The amendment is necessary to deter prospective franchisees from believing that binding arbitration clauses restricting a forum outside of California are automatically unenforceable under California Business and Professions Code Section 20040.5.

The Commissioner also proposes an amendment to subsection (c)(5)(B)(iv) of Section 310.114.1. An amendment to this subsection is necessary because of the 9<sup>th</sup> Circuit Court of Appeal’s ruling in Bradley, *supra*. The required disclosure that a binding arbitration provision “may not be enforceable under California law” is misleading now that the 9<sup>th</sup> Circuit found Business and Professions Code Section 20040.5 preempted by the FAA in the case of arbitration agreements. By reading the current disclosure in a UFOC a prospective franchisee may be misled into believing that the binding arbitration provision is unenforceable.

Complicating matters further with regard to subsection (c)(5)(B)(iv) of Section 310.114.1 is the recent decision by the 9<sup>th</sup> Circuit Court of Appeal in Laxmi v. Golf USA (1999) 193 F.3d 1095. In Laxmi the court refused to enforce an arbitration clause, finding that the parties never clearly agreed to the forum, or in other words, there was no meeting of the minds. In making its decision, the 9<sup>th</sup> Circuit Court of Appeal relied on the disclosures made by the franchisor in the offering circular regarding the forum for binding arbitration as required by subsections (c)(5)(A) and (c)(5)(B)(iv) of Section 310.114.1. The 9<sup>th</sup> Circuit Court of Appeal found that the language in the offering circular was inconsistent with the franchise agreement that provided for the Oklahoma forum, and that there was no evidence that the franchisor would insist upon the out of state forum despite the contravening California law. As a result, the franchisee did not have a reasonable expectation that it had agreed to a forum other than California, and there was no meeting of the minds.

Because the disclosures required by subsections (c)(5)(A) and (c)(5)(B)(iv) of Section 310.114 were not intended to void an agreement between a franchisor and franchisee concerning the location of binding arbitration, it is necessary for the rule to be amended. The Commissioner proposes to amend subsection (c)(5)(B)(iv) of Section

310.114.1 by changing the disclosure from “this provision may not be enforceable under California law” to “this provision may not be enforceable under generally applicable contract defenses, such as fraud, duress, or unconscionability.” Although the FAA has been found to preempt state laws, such as Business & Professions Code Section 20040.5, that invalidate arbitration provisions, not all state laws are preempted. Section 2 of the FAA states:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, **save upon such grounds as exist at law or in equity for the revocation of any contract.** (9 USCS § 2) [Emphasis added.]

Interpreting Section 2 of the FAA, the United States Supreme Court in Doctor's Associates v. Casarotto (1996) 517 U.S. 681, 687, found that “generally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2.”

The proposed amendments will help prevent a prospective franchisee from mistakenly relying upon California Business Professions Code Section 20040.5 to overcome a binding arbitration clause restricting the forum to a location outside of the State of California. Furthermore, the amendments will avoid a court finding that an agreement to arbitrate is unenforceable on grounds that there was no meeting of the minds due to the required disclosure of subsection (c)(5)(B)(iv) of Section 310.114.1.

#### Section 310.114.1(c)(6)

The Commissioner also proposes to add subsection (c)(6) to Section 310.114.1 of Title 10 of the California Code of Regulations (10 C.C.R. Section 310.114.1) to require an additional disclosure by the franchisor when making an earnings claim under Item 19 of the UFOC. The disclosure will only be required when a franchisor makes an earnings claim that does not include costs of sales or expenses.

Under existing law, as set forth in the instructions to Item 19 of the UFOC, a franchisor may elect to provide an earnings claim in its offering circular. If no earnings claim is made, item 19 of the offering circular must include the “negative disclosure” as prescribed in the instructions of the UFOC. If an earnings claim is made, it must be included in full in the offering circular and must have a reasonable basis at the time it is made. In addition, the earnings claim must include a description of the factual basis and the material assumption underlying its preparation and presentation. According to the instructions, the factual basis of an earnings claim includes “significant matters upon which a franchisee’s future results are expected to depend.” As an example, the

instructions provide the factual basis would include “economic or market conditions which are the basis to a franchisee’s operation and encompass matters affecting, among other things, franchisee’s sales, **the cost of goods or services sold and operating expenses.**” [Emphasis added.] However, the instructions also define an earnings claim as “information given to a prospective franchisee by, on behalf of or at the direction of the franchisor or its agent, from which a specific level or range of actual or potential **sales, costs, income, or profit** from franchised or non-franchises units may be easily ascertained.” As a result, it is unclear from the instructions of the UFOC whether or not a franchisor may make an earnings claim that does not include costs of sales or expenses.

The Commissioner proposes to add subsection (c)(6) to permit a franchisor to make an earnings claim that does not include costs of sales or operating expenses. However, this rule will also require that when such an earnings claim is made that the franchisor include a disclosure notifying the prospective franchisee that the earnings claim does not include costs of sales or operating expenses. The proposed rule is necessary to resolve an ambiguity in Item 19 of the UFOC and to prevent franchisees from being misled by an earnings claim that does not include costs of sales or operating expenses.

#### Section 310.156.3 – Internet Advertisement Exemption

Under Corporations Code Section 31156, it is unlawful to publish in this state any advertisement offering a franchise subject to the registration requirements of the FIL unless a copy of the advertisement has been filed with the Commissioner or is exempt from the filing requirement. Corporations Code Section 31156 also provides the Commissioner with express authority to exempt by rule advertisements from the filing requirement.

The Internet, the World Wide Web, and similar proprietary or common carrier electronic systems (collectively, the “Internet”) have facilitated the ability of one person to communicate with a large number of persons. Franchisors have used and will continue to use the Internet, through bulletin boards, home pages or similar electronic communication methods, as a means of advertising their franchise offerings. The terms “advertisement” and “offer” are defined broadly enough under the FIL that advertisements on the Internet (“Internet advertisements”) are included in the filing requirements of Corporations Code Section 31156. (See California Corporations Code Sections 31003 & 31018.)

Because of the uniqueness of Internet communications and because an Internet advertisement can benefit prospective franchisees and the franchisor, the Commissioner finds that the filing of Internet advertisements is not necessary or appropriate in the public interest or for the protection of investors. Accordingly, the Commissioner proposes to add Section 310.156.3 under Title 10 of the California Code

of Regulations (10 C.C.R. Section 310.156.3) to exempt Internet advertisements from the filing requirements of Corporations Code Section 31156 subject to the following conditions:

1. The franchisor files a written verified notice with the Commissioner, on an annual basis no later than December 31, that (a) discloses the Uniform Resource Locator ("URL") address or similar address or device identifying the location of the Internet advertisement, (b) states that any Internet advertisement by the franchisor, or anyone acting with the franchisor's knowledge, will comply with the FIL, and (c) provides the name, address, telephone number and contact person of the franchisor.
2. The Internet advertisement is not directed to any person in the State of California by or on behalf of the franchisor or anyone acting with the franchisor's knowledge.
3. The advertisement includes a statement in at least 12-point font that the website has not been reviewed or approved by the California Department of Corporations, and that any complaints concerning the content of the website may be directed to the California Department of Corporations.

As proposed, Section 310.156.3 also provides that nothing contained in the rule should be construed to affect the Commissioner's ability to bring any action against any person violating any of the provisions of the FIL. In fact, should a franchisor fail to comply with the requirements of the exemption, the Commissioner may issue an order under the broad authority provided in Corporations Code Section 31502 requiring that the franchisor comply with the filing requirements set forth in Corporations Code Section 31156 and the conditions of the order. If an order is issued it would be subject to the hearing rights of the Administrative Procedures Act. (See *also* California Corporations Code Section 31157.)

Recognizing the problems associated with Internet advertisements, on September 9, 2001 the North American Securities Administrators Association, Inc. ("NASAA") adopted a Statement of Policy Regarding Franchise Advertising on the Internet ([http://www.nasaa.org/nasaa/scripts/fu\\_display\\_list.asp?ptid=72](http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=72)). The statement was designed to compliment NASAA's 1998 Statement of Policy Regarding Offers and Sales of Franchises on the Internet ("1998 Policy"), which Section 310.100.3 (10 C.C.R. Section 310.100.3), operative January 25, 2001, was modeled after. The Statement of Policy Regarding Franchise Advertising on the Internet provides two forms of exemptions, one in the form of a proposed interpretive order, and the other in the form of a proposed regulation. Proposed Section 310.156.3 is modeled after the proposed regulation. A copy of the Statement of Policy Regarding Franchise Advertising on the Internet, upon which the Department is relying is available upon request during this rulemaking period.

Although modeled after the proposed regulation of NASAA's Statement of Policy Regarding Franchise Advertising, the language of proposed Section 310.156.3 was modified to ensure its consistency with the existing purpose and provisions of the FIL, as described below.

As with NASAA's proposed regulation, proposed Section 310.156.3 requires the franchisor to notify the Department of its Uniform Resource Locator ("URL") address or similar address identifying the location of the Internet advertisement. This provision is necessary so that the Department may have access to Internet advertisements to verify their compliance with the FIL. Similar to NASAA's proposed regulation, this regulatory action also prohibits the franchisor or anyone acting with the franchisor's knowledge from directing the Internet advertisement at any person in the State of California. This prohibition includes direct forms of communication on the Internet, such as electronic mail to specific prospective franchisees. This provision is necessary to prevent franchisors from relying on the exemption when making direct solicitations. Finally, the proposed rule provides notice that the rule shall not be construed to affect the Commissioner's ability to bring any action against any person violating any of the provisions of the FIL. Consistent with the NASAA proposed regulation, the necessity of this provision is to clarify that this exemption does not preclude the Commissioner's authority under other provisions of the FIL.

This regulatory action also clarifies the method for filing a notice and claiming the exemption from the Commissioner's review and approval process, in three areas. First, Section 310.156.3 requires a notice in writing, setting forth specified information including the franchisor's name, address, telephone number, and contact person. As with other notices of exemption filed with the Commissioner, this provision is needed to enable the Commissioner to identify key information (such as the party) concerning the claim of exemption. Requiring a written notice also provides a consistent means by which the Commissioner can receive and track the information provided by franchisors. Second, the Commissioner's proposed rule requires an annual notice to be filed by December 31st. This provision is necessary to provide the Commissioner with current information, while helping to ensure continuous compliance by the franchisor. Third, this regulatory action requires a verification from the franchisor's chief executive officer, as specified. This provision will help ensure that information in the notice is reliable and credible.

In addition to provisions reflecting and clarifying the notice requirement, this regulatory action sets forth two additional provisions for ensuring accurate Internet advertisements. First, Section 310.156.3 requires a verified statement that the franchisor's advertisements, or anyone acting with the franchisor's knowledge, complies with the FIL. This provision is needed to ensure an appropriate level of internal review by the franchisor. Additionally, the proposed rule requires an Internet advertisement to state that the website has not been reviewed and approved by the Department, and

that any complaints concerning the website may be directed to the Department. Providing notification of this information will help educate prospective franchisees concerning the need to carefully examine these advertisements, while providing complaint information to help protect franchisees.

For these reasons, the additional provisions help achieve an appropriate balance between the interests of franchisors (exempting advertisements from the Commissioner's review) and the interests of the public (preventing misleading advertisements in the marketplace).

### ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that have otherwise been identified and brought to the attention of the Department would lessen any adverse impact on small business.

### DETERMINATIONS

The Commissioner has made an initial determination that the proposed regulatory action does not have a significant adverse economic impact on business.

The proposed regulatory actions to Section 310.11.41 merely clarify the state of the law concerning binding arbitration agreements, and the effect of California Business and Professions Code Section 20040.5. Furthermore, the proposed regulatory action clarifies an ambiguity included in the instructions of Item 19 under the UFOC, and simply requires that an offering circular include an additional disclosure under certain circumstances. Furthermore, the proposed adoption of Section 310.156.3 will not have an adverse economic impact on small business because it exempts Internet advertisements from registration.